

Capstone Winery¹

On a warm summer afternoon, Michelle McGraw, CFO of Capstone Winery, gazed out her oversized office window and admired the long rows of vines that stretched across an expanse of dry fields. This summer had been an ideal growing season for the limited supply of estate wines that her firm produced, with minimal rain and plenty of sunshine throughout the past several months. As McGraw admired the beauty of the firm's vineyards, her mind was more focused on other aspects of the business. Although the firm's high-end estate wines had strong brand recognition, they comprised only half of its overall product mix in recent years. Their property had neighbors on all sides, so the estate wasn't getting any bigger. Thus, growth could only be achieved through price increases rather than increases in quantity. As a potential source of higher growth, Capstone had also developed a reputation as a provider of winery services to smaller estates in the Napa region.

Most of the smaller family-owned wineries do not have a bottling line on site, so they hire firms such as Capstone to convert their precious inventory from bulk to bottle. Other estates have no winery at all and would hire Capstone to take their grapes through the entire winemaking process from crush to bottle. Located just off Highway 29, the primary north-south thoroughfare in Napa Valley, Capstone was ideally situated for the large-scale distribution and bottling business that had over time developed into the predominant revenue-generating side of the firm's product mix. The services division was especially attractive because it generated a higher gross margin and required neither inventory nor any substantial purchases of materials. The only meaningful inputs required to generate services revenue are labor and equipment.

The Tank Project

McGraw had several major decisions to grapple with. Capstone's CEO, Harold Henderson Jr., had charged McGraw with evaluating the economics of several medium-term capital investment projects, and also with analyzing the winery's overall capital funding needs. One capital expenditure involved the purchase of several new 25,000 gallon stainless steel tanks which would allow Capstone to substantially increase its services revenue. McGraw has already completed the analysis of this project and reached the conclusion that the purchase of these tanks represented a positive NPV of nearly \$1M for the company (see exhibit 2). Furthermore, pursuing the tank project would allow Capstone to take on a high-profile new brand that was looking for winemaking services. This was important to the CEO on a personal level because the potential client was a close friend of Henderson's and acquiring this client would elevate Henderson's social standing in the valley. Henderson was so excited to move forward that he has already signed a purchase agreement with the tank vendor that locked in pricing, but included a 10% cancellation fee.

The purchase of new tanks would involve an initial outlay of approximately \$10 million, but would generate additional annual sales of \$3 million in 2022, \$5 million in 2023, and then sales increasing at an annual rate of 10% thereafter. Incremental sales would cease after the ten year useful life of the tanks. Hence, the tanks would be depreciated to zero on a straight-line basis over ten years. After McGraw presented her analysis to Henderson, the CEO decided that the company should move forward immediately with this production expansion. McGraw anticipated that the purchase, installation, and payment for the equipment, which would be accounted for as a capital expenditure due to the long-lived nature of the assets, would be completed by the end of 2021. The new

¹ This case was prepared jointly by Matthew D. Cain (University of Notre Dame) and Stephen B. McKeon (University of Oregon). All case details are fictitious.

equipment would be fully functional and capable of generating the expected incremental revenues for fiscal 2022 and beyond.

Financing Issues

Typically, Capstone sells about 90,000 cases annually at prices ranging from \$84 per case to \$284 per case, with an average of \$112 per case. Unfortunately, recent turmoil due to COVID-19 had an impact on the firm's financial situation in 2020. Year-over-year sales declined about 10% in 2020 due to cutting back their cased goods and reduced demand for services. Fortunately, though, the winery had managed to maintain a relatively constant gross margin on its existing sales, which helped to minimize any adverse impacts from reduced sales. Moreover, McGraw expected fiscal 2021 sales to rebound to 2019 levels and she also forecast sales to remain at 2021 levels in 2022 and 2023 since production of cased goods was constrained by the supply of grapes and services were constrained by production capacity (excluding incremental services sales from the tank project).

The most significant issue facing McGraw right now involved the firm's long-time local bank, Napa Financial, Inc. Last week, McGraw received a letter from the winery's sole lender to inform her that Napa Financial would be scaling back its lending to all banking customers in an effort to conserve capital. Apparently, Napa Financial had spread itself a little thin by lending to many regional wineries and agricultural businesses, and was now cutting its lending commitments to most customers by up to 50% over the next three years.

McGraw had always managed the winery's finances in a conservative manner, so she anticipated that the firm's cash cushion would buy some time in evaluating all available options. She feels the winery needs a minimum cash balance of around \$5 million to fund working capital requirements, but they have been holding some excess cash on the balance sheet that they can immediately start applying to the line of credit. They have been maintaining a \$17 million balance with Napa Financial's revolving line of credit, which costs the firm 7% in interest, calculated on the prior year's closing balance. For the purposes of this case, you can treat this loan as long term debt.

Napa Financial's letter informed McGraw that the bank would be decreasing the maximum available commitment from its current limit of \$23 million, to \$20 million at the end of 2022, and to \$17 million at the end of 2023. McGraw knows that with the upcoming capital expenditure, she may need to draw down on a greater portion of the line of credit in order to maintain the firm's minimum cash balance. She intends to pay down the loan as much as possible going forward, but she isn't sure whether the firm will be able to comply with credit limits the bank is imposing.

Additional Assumptions and Outlook

In order to forecast Capstone's financial position over the next several years, McGraw assumes that cost of goods sold (COGS) and operating expenses will represent the same proportion of total revenues as they have in recent history. Other than the new fermentation tanks, the firm typically purchases new long-lived assets at a rate equal to the \$2 million annual depreciation on existing assets, so that net PP&E remains constant. The firm's effective tax rate is 21%.

Because the winery operates on a production schedule that differs greatly from traditional manufacturing firms, it maintains a large quantity of inventory on hand, as the wines age in American and French oak barrels for 12 to 24 months before they are converted to cased goods. McGraw does not expect the ratio of COGS to inventory for these products to change in the next few years.

Since much of the cost of goods sold is derived from the aging process, McGraw allocates a portion of the firm's expenses incurred each month to the inventory value. These include cellar worker salaries, rent, utilities, and depreciation of items in the winemaking process. About 35% of the cost of goods sold on the cased goods represents purchases of things like glass, corks, and grapes, which the winery promptly pays in about 35 days. A/P is the winery's only current liability because the bank loan has a maturity over 12 months.

McGraw has been trying to collect on the winery's sales more quickly, but doesn't anticipate that she will be able to improve upon the historical rate without some sort of discount.

As a majority owner of Capstone Winery, Henderson has adopted a policy of paying out \$1 million in annual dividends regardless of the firm's profitability. He uses his portion of the dividends to supplement his living expenses (Napa is an expensive place to live!) and occasionally invests the remainder in startup business ventures. He is not obligated to continue the dividend policy, but the extra income is nice and the other owners have grown accustomed to receiving their dividend check each quarter. The remaining 48% ownership of the winery is scattered among other managers and a few small outside investors, so the control of the company rests in Henderson's hands. Henderson enjoys his role as CEO of a winery, and derives more pleasure in this position of prominence than he does from the annual salary and dividends associated with the employment.

Options

McGraw starts to jot down a list of options available to the firm should the reduced line of credit be insufficient to meet Capstone's financing needs. Here are the first four that come to mind:

- (1) She could forego the purchase of the new fermentation tanks.
- (2) She has contacted several larger banks in the hope of securing a larger line of credit. Unfortunately, even the larger national banks are reluctant to extend credit to firms like Capstone due to the company's risky inventory collateral. One Italian bank, Banca di Murano, has offered a \$25MM line, but the winery would have to endure a long and arduous credit review for approval and would also have to agree to store its inventory as collateral for the loan in a bank-owned warehouse. Apparently, the bank has expertise in this type of collateral arrangement through its customer experience with producers of Parmigiano Reggiano cheese. This option would cost Capstone approximately \$180,000 per year in extra storage fees.
- (3) The only other alternative that McGraw has come up with involves selling equity to either a larger, well-funded firm in the industry or to a private equity group. This might mean selling all of the equity in the firm or selling just a portion. She has heard rumors in the valley that one of Capstone's primary competitors, Magenta Wine Co., wishes to further expand production and their winery services business in the Napa Valley by acquiring a smaller established winery with large scale production capacity; Capstone fits this description perfectly. The combined company would likely create synergies.
- (4) She is open to any other suggestions that would allow them to pursue the tank project and remain within the bank limits.

Note: All numbers presented in the case are in real dollars (no adjustment for inflation is necessary).

Assignment

Part I (60%): Pro forma statements and financing strategy

Construct pro forma financial statements (income statement and balance sheet) for Capstone Winery for the next three years. You should first construct the base case, assuming no tank project, and then a second set that adds in the effects of the project when financed by debt. Attach both sets of pro forma statements to your report as Appendix “A” and “B.” Each set should fit on a single page.

For the purposes of these pro forma statements, you should ignore the bank limits stated in the case; you should use the line of credit as the plug.

The goal is to establish whether they can do the project with their current loan without making any operational or financing changes. You should find that they *cannot* (bank balances will exceed the limits in some years). This is the problem they are trying to solve with one of the options. In other words, they have a positive NPV project that they would like to do, but they face financing constraints.

Summarize your analysis with a brief narrative that addresses the following questions:

- How much bank debt will Capstone need at the end of each of the next three years if they pursue the project? How do these estimates compare to the limits proposed by Napa Financial?
- What are the pros and cons of each option Capstone is considering? Note that you are not required to do new spreadsheets on the options, just describe the pros and cons of each in words and you can do small calculations as part of the narrative if needed. If possible, try to explain *why* the particular items are pros or cons.
- Which of these options would you recommend and why?

Part II (40%): Valuation

The goal of Part II is to estimate the acquisition value of Capstone. Perform the spreadsheet analysis described below and write a one-page summary of your findings.

First step is a DCF analysis. Start with your pro forma statements from Part I including the tank project to value Capstone on 12/31/2020 using discounted cash flow analysis. You do not need to forecast financial statements for years beyond 2023 because you will use a terminal value. Be sure to include enough detail so I can see how you calculated the operating cash flows, capital expenditures, change in net working capital, and terminal value. Assume the appropriate discount rate is 12% and that the free cash flows grow at 1% in perpetuity beyond 2022. You should be able to do all the required calculations for this DCF on one page. Attach this analysis to your report as Appendix “C”. What is the enterprise value implied by your DCF analysis? After calculating enterprise value via DCF, calculate equity value.

Second, value the business using comps. There are two segments of the business, the brands (case sales) and the services business. Assume that the market price for selling the services business is 1.6x sales.

The attached excel file provides transaction data from recent wine brand sales. Use regression analysis to estimate a revenue multiple, you can check “constant is zero.” Using Capstone’s projected 2021 revenue from case sales, what does this imply for the value of the Capstone wine brands?

Adding the value of the services business and brand together, and then taking into account the excess cash and debt, calculate estimated equity value in an acquisition. What is the percent premium or discount of this figure compared to the DCF equity value number? Why might buyers pay a higher or lower value than the one you computed using DCF?

Attach your regression output and the calculations for equity value as Appendix “D”.

Exhibit 1

<i>Income Statement</i>		
<i>(in \$mms)</i>	2019	2020
Revenues-Case sales	\$ 10.00	\$ 9.00
Revenues-Services	\$ 10.00	\$ 9.00
Total Revenue	\$ 20.00	\$ 18.00
less: COGS (cased goods)	\$ 6.50	\$ 5.85
less: COGS (services)	\$ 5.00	\$ 4.50
Gross Profit	\$ 8.50	\$ 7.65
less: SG&A Expenses	\$ 2.00	\$ 1.80
less: Depreciation	\$ 2.00	\$ 2.00
Operating Profit	\$ 4.50	\$ 3.85
less: Interest Expense	\$ 1.19	\$ 1.19
Earnings before Tax	\$ 3.31	\$ 2.66
less: income tax	\$ 0.69	\$ 0.56
Net Income	\$ 2.61	\$ 2.10
<i>Balance Sheet</i>		
<i>(in \$mms)</i>	2019	2020
<u>Assets</u>		
Cash	\$ 5.76	\$ 7.52
Inventory	\$ 8.01	\$ 7.21
Accounts Receivable	\$ 2.30	\$ 2.07
Total Current Assets	\$ 16.07	\$ 16.80
Gross PPE	\$ 42.00	\$ 44.00
less: Accumulated Dep.	\$ 24.00	\$ 26.00
Net PPE	\$ 18.00	\$ 18.00
Total Assets	\$ 34.07	\$ 34.80
<u>Liabilities & Equity</u>		
Accounts Payable	\$ 0.22	\$ 0.20
Bank Debt	\$ 17.03	\$ 16.68
Common Equity	\$ 9.00	\$ 9.00
Retained Earnings	\$ 7.82	\$ 8.92
Total Liabilities & Equity	\$ 34.07	\$ 34.80

Exhibit 2

NPV Analysis of Tank Project

(in \$mms)	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Capital Investment	10.00											0.00
Revenues-Services		3.00	5.00	5.50	6.05	6.66	7.32	8.05	8.86	9.74	10.72	
less: COGS (services)		1.50	2.50	2.75	3.03	3.33	3.66	4.03	4.43	4.87	5.36	
less: SG&A Expenses		0.30	0.50	0.55	0.61	0.67	0.73	0.81	0.89	0.97	1.07	
less: Depreciation		1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	
Operating Profit		0.20	1.00	1.20	1.42	1.66	1.93	2.22	2.54	2.90	3.29	
Taxes		0.07	0.35	0.42	0.50	0.58	0.67	0.78	0.89	1.01	1.15	
EBIT(1-T)		0.13	0.65	0.78	0.92	1.08	1.25	1.44	1.65	1.88	2.14	
Operating CF		1.13	1.65	1.78	1.92	2.08	2.25	2.44	2.65	2.88	3.14	
A/R Balance		0.35	0.58	0.63	0.70	0.77	0.84	0.93	1.02	1.12	1.23	0
Change in WC		0.35	0.23	0.06	0.06	0.07	0.08	0.08	0.09	0.10	0.11	-1.23
Total CF	-10.00	0.78	1.42	1.72	1.86	2.01	2.18	2.36	2.56	2.78	3.02	1.23
Discount Factor	1	0.89	0.80	0.71	0.64	0.57	0.51	0.45	0.40	0.36	0.32	0.29
Present Value of CF	-10.00	0.70	1.13	1.23	1.18	1.14	1.10	1.07	1.03	1.00	0.97	0.35
NPV	0.92											